DOES CHINA MEET THE PRECONDITIONS FOR LONG TERM INVESTMENT IN REAL ESTATE?

by Bowen H. "Buzz" McCoy, CRE

As part of an Urban Land Institute study tour to China last spring, we visited three cities: Beijing, Xiamen and Shanghai. This article summarizes the long term investment prospects for China at the present time, with special emphasis on political, economic and social factors, as well as an examination of market conditions. The data gleaned in this article from the study tour will prepare us to become "China Watchers" in preparation for The Counselors' 1997 High Level Conference, "China Revisited."

The study tour program was developed by S. L. Chen, a U. S. citizen who was born in China. Mr. Chen has devoted his career to investment banking and management consulting involving China. He pioneered secondary trading in China government debt, and he helped to re-open the Shanghai Stock Exchange. In the interests of full disclosure, the author wishes to acknowledge that one of his daughters is happily married to one of Mr. S. L. Chen's sons.

The choice of Beijing and Shanghai as destinations was obvious; they are the Washington D. C. and New York City of China. We also wished to visit a second tier city which was benefiting from strong development and was less dependent upon the central government. Xiamen (formerly Amoy) fit the bill. Not only is it located in south China (a long way from the central government), but it is the mainland deep water port nearest to Taiwan, and it would benefit spectacularly if any rapprochement occurred. Other interesting information on Xiamen: the islands of Quemoy and Matsu lie offshore, and it is a city where Mr. Chen is quite active as an entrepreneur.

Preconditions For Long Term Investment

Here is a short list of preconditions for long term investment in any emerging market country. We are studying real estate investment in particular, but these conditions might apply to any form of long term investment. These pre-conditions are being evaluated here against political, economic and social criteria prior to drawing a conclusion. I am indebted to fellow CRE Christopher Jonas for sharing some of these criteria at the High Level Conference in Scotland.

(1) There is a general perception of confidence about where the country is headed. No major conditions must be set. No major hurdles need be overcome.

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(2) There is a broad diversity of investors who are interested. We will not be out on a limb.

(3) There is an ability to value investment returns which is generally understood, professionally supported and linked to the local currency.

(4) There is the prospect of a secondary market. There is a pre-existing exit strategy—a way out.

(5) There is a professional data base readily available providing comparable rents, costs, sales prices and the like. (Query: Does such a data base exist for real estate in the U. S.?)

(6) There is the ability to repatriate rents, dividends or sale proceeds.

(7) The local currency is convertible externally. There is a free currency market, as well as ability to hedge the local currency.

(8) There are systems in place to manage the investment.

(9) There is a regulatory system in effect to regulate the marketplace from malpractice and corruption.

(10) There is a rule of law and an established process to resolve conflicts between international investors and local partners: the decisions of international arbitration agencies are enforceable in the local court system.

(11) Investment returns include a risk premium which will adequately compensate for all the risk. Investments in the emerging market will clearly outperform investments at home.

For many readers, the answers to these queries may be apparent without reading further. If all these conditions were met, China would be a mature market. This article attempts to utilize the following analysis as a means of conveying some of my impressions from the study trip. In the conclusion, I will attempt to indicate an investment strategy which might work at the present time in an emerging market nation such as China.

Political Conditions

For those of us in the West who are trained to think linearly—or since the computer age, binarily—the yin and the yang of the Orient, which is very much a reality, makes assessment truly puzzling. Commentators on China have come up with wildly optimistic as well as wildly pessimistic predictions for the evolution of the political system which must replace the current aged leadership.

A threshold query might be: "Who is Deng?" Deng is the ruler of China. Is he head of state? No. Is he head of the Communist Party? No. Is he generalissimo of the Peoples' Liberation Army? No. The only title the *Los Angeles Times* could come up with for Deng, is chairman of the All China Bridge Association (presumably contract and not structural). Identifying future leadership is a problem inherent for prospective "China Watchers."

A more optimistic scenario might call for gradual change from the top. A continuation of Dengs' "to get rich is glorious" policy has provided a vision and a relative stability since its promulgation in 1979. This has been one of the most stable political eras in China during the past 150 years. Certain economic zones and certain cities have enjoyed exponential growth and resulting wealth as foreign capital has poured in.

Economists insist that the only persistent underpinning for a free political system is an open and free market system. Sectors of China have headed this way for the past 15 years with the support and even the participation of the senior party leadership. Yet many commentators observe that China today is a system in which authoritarianism has fragmented. There are both vertical and horizontal bureaucracies, with huge power vacuums everywhere. Dissent is crushed, yet the taxes are not collected. It is a structure which is elaborate, but institutionally weak. Governance is personalized. It is a rule of men and not of laws. It is a government of relationship, bribery and corruption. The nation state is in a twilight zone, moving out of authoritarianism into some form of market socialism. The ideological vacuum at the core leads to individual bargaining instead of rule under law. Regulations are constantly changing, and they are seldom promulgated, giving great power to the bureaucrats who have a copy of the law.

Local municipalities compete with Beijing for foreign capital. Individual state ministries compete for foreign capital. There is chaos in central planning, fragmentation, regionalism and wanton regulatory change. At the center is a cadre of old, weak leaders. There is no charismatic leader or an agreed upon vision. What set of established institutionalized values will govern irregardless if the current movement toward individual entrepreneurship persists or goes the way of the Cultural Revolution or the Great Leap Forward?

The optimistic theory of slow democratization from within flounders on the realities of having the will to re-engage tens of millions of workers in new jobs, reforming state ministries and industries, providing a long term vision to comfort the populace during the accompanying individual economic hardship and democratizing the institutions without losing control. Other scenarios would include a Sun Yat Sen-type of emerging charismatic leader from outside the present structure who would provide the will to manage change and the vision to comfort the populace during the hardship which will certainly accompany it. This, too, is one of the

more optimistic turn of events. Less optimistic would be a military coup, a break up of China into super-regions, a fall back to the old war lord society and the like.

The author has no basis for guessing at the political outcome. The military could certainly play a key role. Just who are the Peoples Liberation Army (PLA) prepared to shoot? The people? There was some ambivalence in 1989, and there would probably be a great deal more today. Even the military is engaged in the economic boom. The PLA owns a few super high rise multi-use structures. A new form of neo-fascism? This is not as strange as it sounds. In Bhutan, the army has a monopoly concession to brew and sell malt whiskey to supplement its pension plan. The odds are there will be an authoritarian government in China with accompanying human rights abuses, conscripted labor, lack of freedom to travel internally and the like for as long as any prudent investor cares to project.

From this brief and superficial analysis, we can comfortably conclude that pre-condition #1 is not met. There is not an unconditional premise of political stability. Moreover, there is no clear rule of law, protection against corruption, regulation against malfeasance, nor a process that is enforceable in the local court system for resolving disputes with local partners.

Economic Conditions

Buying Power

Deng predicted that national wealth would quadruple between 1979 and 2000. His goal will be exceeded. Foreign investment has poured in, and many Chinese have escaped from their own economy into the world economy. There is a sense of unreality. State cadre workers make about $30 U. S. per month. They pay $1 per month as rent for a small apartment in a seven story walk up which, although quite new, has the appearance of the South Bronx. Such an individual has a bicycle, a TV, an electric fan and a small refrigerator. The cooking facilities are one or two gas burners. There is no bath tub or shower stall. They probably eat two or three meals a day at the state enterprise. Both family members work, and their single child is cared for by a grandparent or through schooling and child care. They save 40 percent of their income. There are virtually no private automobiles, cellular telephones and the like. These luxury items come as prerequisites for higher officials in state ministries or industries.

Yet there is also a veneer of much greater wealth. Some of it comes as remittances from overseas Chinese relatives. Some of it comes from true entrepreneurship in this boiling economy. Some of it comes from corruption. As the highly regulated local economy runs into the world economy, inflation runs rampant. Official inflation at present is 15 percent. Unofficially it is said to be 20 percent per annum, but it has been as high as 40-50 percent per annum. The state controlled central bank runs the economy with rigidity, on a stop/go basis, turning on and off the credit lines to the local banking system. At present the economy is in a stop phase, due to excessive real estate speculation, and it is virtually impossible to borrow for working capital in the local Chinese currency.

Employment

China's employment in agriculture is about 73 percent, as compared to 5 percent as the Organization for Economic Cooperation and Development (OECD) average. If China were to mechanize its farms, there would be an under employment problem for hundreds of millions of individuals. Yet, at present, it is problematic whether China will be self-sufficient in grain. There are said to be 100 million persons unemployed at present in the countryside and 10 million unemployed in the cities. Each major city has pass points, preventing those in the countryside from coming in. Yet there are said to be a couple of million floating countryside people in both Beijing and Shanghai. They are invisible as otherwise they would be arrested on the street. It is said that state industry has 100 million employed, of which at least 25 million are not needed in their jobs. Thus, the unemployment potential for China is huge, and any restructuring of agriculture and industry will present very serious political problems.

Currency/Capital

The local currency is not convertible. Tourists can purchase RMB (local currency) at about 8:1 to the U.S. dollar. Estimates of the real market, if the RMB were fully convertible, range from 12:1 to 15:1. Thus, a free float would produce a situation far more serious than the one currently being suffered by Mexico.

There is a serious shortage of investment capital, even though China enjoyed the largest foreign investment inflows of any nation in 1994. Last year $30 billion of capital flowed into China. About two-thirds of the capital inflows were Chinese (25 percent Hong Kong Chinese and 40 percent overseas Chinese). This amounted to about one-third of the world's foreign investment last year. As was very visible on the study tour, about two-thirds of the foreign investment went into real estate. This year foreign investment is estimated to drop one-third to $20 billion, partly as a result of overbuilding as well as the Bank of China crackdown on speculative building. Yet, at the same time, China's infrastructure is primitive. China has huge needs for roads, railways, airports, power plants and port facilities. Much of the existing infrastructure is poorly constructed.

It has been suggested that Hong Kong will be kept as a market to the world by the Chinese for 50 years following 1997. It has also been suggested that the reason for this is the value of having the Hong Kong dollar as a currency. Further, it has been suggested that without the Bank of China having the resources to support it, the world currency dealers could overnight destroy the Hong Kong dollar.

Thus, the momentous problems facing the Chinese are unemployment and inflation. The following section will discuss in more detail the will required to sustain the populace through any economic transition. In terms of the preconditions for long term foreign investment, we may now check off, negatively, returns linked to local currencies, repatriation of investment returns and currency convertibility.

Social Conditions

Demographics

An incredible strength of China is the homogeneity of its populace. Of the 1.2 billion population, 92 percent are of Han ethnicity and share a 2,000 year history. Individuals living in the city are much better off than they were in 1979. There appears to be an energy and an optimism about the people. Having made five trips to China since 1984, this author is now more impressed by the disappearance of Mao uniforms, the color and ebullience of the street life, the local entrepreneurship and the bustle of the retail stores. However, great challenges lie ahead.

Company Restructuring

One challenge is the 25 million workers who must be restructured from state industry. A woman we had lunch with talked of her father. He works in the Ministry of Mines where he does nothing all day but read the newspaper. When he comes home, he does all the shopping, cleaning and washing, because her mother is working overtime for a foreign manufacturing company. Recently in the U.S., companies such as Sears, General Motors, Du Pont, AT&T, IBM and others have restructured hundreds of thousands of jobs. Eliminating layers of management have resulted in sharply improved competitive ability and profitability. This occurred in a market economy, where it required a decade of needling by stock and bond analysts, leveraged buy out attackers and Japanese competitors to overcome the inertia and get the job done.

I submit it is not possible for us to understand what it will take for the Chinese bureaucrats to do the same. For those of us who have spent our entire lives enjoying and applauding a free market economy, we have no sense of the mind-set of those who have risen to positions of wealth and influence by disdaining such a system. How can individuals who have lived their lives in such a different system be expected to have the will to face political instability by firing one in four individuals and emulating our system?

Family Life

Yet another challenge is the policy of one child per family which has led to unprecedented abortion and infanticide of female children. The United Nations reports that the normal ratio of girl babies to boy babies is 115:100. In China it is 49:51. The demographic impact of this massive social "experiment" is also difficult to comprehend.

As Chinese families move from the closed society of the Cultural Revolution to the global marketplace in a single bound, they are free to pluck whatever they wish from the consumerism shelf of the world without going through the 100 years of the industrial revolution that the West experienced. Preliminary Gallop Polls in China indicate strong preferences for color TVs, washing machines and VCRs. The automobile is a luxury, owned only by the state ministries, but within a decade or two aspirations will no doubt reach this level as well. In major cities such as Beijing and Shanghai, literally hundreds of high rise structures are being built with minimal parking. When China turns away from the bicycle to the automobile, all these structures will be isolated from the then preferred means of transport. Imagine also a nation of hundreds of millions of student drivers.

The key descriptive word in China today is change. Of course, China's social policies have embodied change throughout its history. I wonder how seriously the average citizen might take this sudden veer toward capitalism. Even with all the economic freedom, virtually every citizen is still the subject of a dossier which remains with them all their lives. They are not privy to the content until they require something of the central government or try to leave the country.

Revolving Door In And Out Of China

A major choice for Chinese of influence today is to get rich or to help their people. Getting rich seems to be the current preference. We were told that all the rich and powerful Chinese want to get their children out of China and into a Western university. Ironically, at the same time, the overseas Chinese are stumbling all over themselves to get back inside China. Hence, $20 billion of overseas Chinese investment came back into the country last year.

Market Conditions

Office markets in Beijing and Shanghai are extraordinarily tight at present, with thousands of foreign firms seeking world class office space where there is limited supply. Rentals are among the highest in the world, or as much as $100 a square foot per year. At present there are approximately 100

high rise, mixed use projects under construction in Beijing and almost 400 in Shanghai. In Shanghai, there will be about 40 million square feet of office space added in the next three to four years. Otis sold as many elevators in China in a month last year as they sold in the U.S. the entire year. Thus, there is classic overbuilding 1980s style against an imponderable market demand and office rentals will plummet to levels we cannot now predict; but they will go to at least one-third of their present level. As noted, the overbuilding is fueled by overseas Chinese money, international banking funds and competing Chinese ministries. Likewise luxury style villas renting for $200,000 a year or selling for $500,000 and up are vastly overbuilt. They are a target of the Bank of China's credit restraint. In all the cities visited, we viewed half completed hulks of such property. There appears to be at least 10 retail mega-projects under construction or being planned in Beijing, including the infamous Li Kha Shing/McDonalds site. Some of them are several city blocks in size. All are bicycle or street accessed. One has to wonder if the overseas remittances, the foreign travelers and the corruption payments will provide sufficient buying power to support these ventures.

The McDonalds site is a classic example of regulatory anarchy. All the land in the country is owned by the government. Most of it is granted land, which can be conveyed by the government. The rest is allocated land which has been granted by the government to a state agency. In most cases, the agency itself cannot reconvey the land without government approval. McDonalds was on allocated land, and either did not know it or did nothing about it. Thus, the government felt justified in taking the land away from McDonalds and giving it to Li Kha Shing. What other arrangements may have been made, the author knoweth not.

There is a tremendous market for lower class housing, running into the billions of square feet. The market for such housing today is the state ministries or businesses which purchase such structures and then rent them to employees at a highly subsidized rate. This market is not quality or amenity conscious. One wonders how many U.S. developers would like to be pictured on the cover of their local Sunday supplement in front of their newly developed, South Bronx style seven story walk-up. There is also a good market for industrial property and for all types of infrastructure.

The best market for a Western investor is a build-to-suit office or industrial property for a Western tenant who will pay rent in a hard currency and possibly put a year or two of rental payments up front as construction finance. These deals have been done, but the current overbuilding would seem to take away this market opportunity.

Construction costs come close to Western standards for high rise buildings once all the indirect costs are figured in. A job requiring six architects in the U.S. may require 30 in Hong Kong and 300 in China. In some cases workers appear to be dragooned off the farms, and they live in the building during the construction cycle. They have to be trained in all aspects of city life. Construction finishes are sub-standard by Western expectations.

Examples Of Manufacturing And Market Successes In China

In a huge industrial tract outside Beijing, we visited the Motorola operation. They have doubled their original capacity in an attempt to keep up with the burgeoning market in China for cellular telephones. These sell for about $3,000 a copy, or 10 months' wages. They cannot keep up with the market which is mainly state enterprises and wealthy individuals. Of most import, Motorola has established programs to train and house their employees. A long term Chinese employee of Motorola will own his own home. Training standards are the same as in any Western country where Motorola operates; likewise, for the Holiday Inns visited in Xiamen. They now have 54 hotels in China. Holiday Inns run a training university in Beijing, and they also continually train their staff onsite at each property. They opened in Xiamen with 44 middle managers, all ex-patriots.

Three years out, 75 percent of those jobs have been filled with local Chinese they have trained. If China makes the transition from within, it will be in large part due to the good work of Western companies making the kind of effort required to bring their employees as stakeholders into the market economy. It cannot be determined from this analysis if the preconditions for data base information and local management systems have been met. There are a large number of market participants, so you will not be alone; but it sure helps to be Chinese.

Land Investment

As already noted, one must be very careful about land transferability. Information is hard to come by, and locals will often give assurances which may be true. The rule by man rather than by law makes legal certainty extremely difficult. Capital gains taxes may be levied ex post facto, if your speculative profits seem too high. A good hedge is to have a local partner. Yet, there have been cases where local partners collude with planning agencies as their proxy in negotiating what the local partner could not attain for himself.

Under current conditions of credit restraint, local finance is extremely difficult. Your project must be all equity, or it must stand up to the scrutiny of the international money and capital markets. As

noted, a great deal of finance is from offshore Chinese equity or prepaid rents or purchase options in hard currency.

Construction will probably be performed by huge state owned construction companies with 50,000 or more employees and concomitant feather bedding and unskilled labor trades resulting in higher costs than one might anticipate. There will be no bidding process or critical path construction planning process.

Most foreign investors are drawn to Beijing or Shanghai. In Beijing the acute shortage of top grade office and residential space has resulted in high rental rates. In 1994, top grade office rentals were about $90 per square foot annually, and top grade residential rental rates were about $80 per square foot annually. As noted, there is a large number of office and residential projects due to be completed in 1995 and 1996, which make future rent levels problematic. Prime street level retail rents are as much as $225 per square foot annually, with some 10 million square feet of retail due to be completed within the next three years. Beijing hotel occupancies are close to 80 percent, with average room rates in the five-star hotels around $170 per night.

Shanghai is little different, with perhaps a greater oversupply coming on the market. Street level retail along Nanjing Road achieves annual rents between $130 and $250 per square foot annually. Residential property suitable for expatriate living would sell for between $150 and $300 per square foot. Presales of office space range between $180 and $350 per square foot, with about 30 million square feet coming on the market by the end of 1997.

Conclusion

It comes as no surprise that, in my opinion, most of the fundamental conditions for long term investment are not fulfilled in China at the present time. So much for intellectual analysis. Why then did China receive one-third of the world's investment dollars last year? In part because of the offshore Chinese affinity. Also, up until last year, it was still possible to receive a three year investment pay-back on most major investments. Often the pay-back was in a hard currency as well.

The fact is that early investments in emerging economies are short-term investments. Discounted cash flow analysis is not appropriate. Money must come back in two or three or four years. Returns must run at 30-40 percent a year. Until the recent spate of overbuilding and the Bank of China negative reaction to speculation, China was a great place for short term investment in real estate. Unfortunately, real estate is, by its nature, not a short term asset. Liquidity must be provided by presales of office buildings, apartments villas and the like.

There should continue to be good investment opportunities in second tier cities, particularly where a reliable Chinese partner is involved. Major U.S. pension funds may wish to place a small portion of their high risk funds into Chinese real estate. A $30 billion dollar fund might risk a couple of hundred million dollars against a 30-40 percent return.

As for me, while we were in Xiamen , S.L. Chen and I became proud grandfathers for the first time. My granddaughter's name is Katherine Yu-Ting Chen. I now have a long term investment in China, and I love it.